

## Gross Income from Personal and Investment Activities

### Chapter 4

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## Federal Income Tax Formula

**Income** (broadly defined)

Less: Exclusions

**Gross Income**

Less: Deductions for AGI (*Above-the-line deductions*)

**Adjusted Gross Income** (*"The Line"*)

Less: Itemized or Standard Deduction (*Below-the-line deductions*)

Less: Personal and Dependency Exemptions

**Taxable Income**

**Tax on Taxable Income**

Less: Tax Credits

**Tax Due (or Refund Due)**

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## Chapter Overview

- ▶ **When is Income Taxed?**
  - Tax Year and Accounting Method
  - Realization and Recognition
  - Sources of Income
- ▶ **Investment Activities**
  - Income
  - Exclusions
- ▶ **Personal Activities**
  - Income
  - Exclusions

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## Taxable Year

- ▶ Generally 12-month period
- ▶ For most taxpayers, is calendar year
- ▶ Fiscal year can be elected if adequate records are maintained
- ▶ 52-53 week year
  - Ends on specified day of week of last month of tax year

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## Methods of Accounting

- ▶ Cash-Basis taxpayers recognize income when it is received (or set aside)
  - Individuals and some businesses
- ▶ Accrual-Basis taxpayers recognize income when it is earned
  - Most businesses are accrual-basis taxpayers
- ▶ Hybrid Method
  - Used when inventory is a material income producing factor

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## Accrual Method

- ▶ Income is earned when
  - All events have occurred to fix taxpayer's right to the income
  - The amount can be determined with reasonable accuracy
- ▶ Claim of Right Doctrine
  - Amounts received are subject to tax even if in dispute
  - If payment has not been received, and is disputed, no income recognition

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## Exceptions to Accounting Method Rules

### ▶ Cash Method

- Original Issue Discount (OID)
- Constructive Receipt
- Cash received with obligation to repay

### ▶ Accrual Method

- Prepaid income – included when received
- Advance payment for goods and services
- Claim of right doctrine

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## Special Accounting Methods

### ▶ Applies to long-term contracts

- Completed contract method
  - Revenue is not recognized until the contract is completed
- Percentage completion method
  - A portion of the expected revenues are recognized at regular intervals based upon the percentage of completion of the work

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## Realization vs. Recognition

- ▶ **Realization** occurs when income is received, or when a gain on a property transaction becomes fixed.
- ▶ **Recognition** occurs when the income is reported on the tax return.
- ▶ All realized gains are recognized, unless an exception applies.

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## Recognition of Income

- ▶ Follows realization principal from accounting
  - Income is recognized (taxed) when realized unless an exception applies
- ▶ Generally, any accretion to wealth is income
  - Mere appreciation in wealth (economic income) that is not fixed and measurable at a particular point in time (i.e. objectively determined) is not considered realized income
  - Congress has excluded certain accretions of wealth from the definition of income for tax purposes

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## Recognition of Income

- ▶ Income is recognized if received
  - In cash
  - In kind (property or services)
    - Barter transactions
- ▶ Income does not include recovery of capital investment (capital recovery doctrine)

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## Sources of Income

- ▶ **Investment Income**
  - Doctrine of the Fruit and the Tree – income taxed to owner
- ▶ **Employment Income**
  - Doctrine of the Fruit and Tree – income taxed to earner
  - Self-employment Income
  - Wages
- ▶ **Income from Personal Activities**
  - Alimony

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## Income Tax and Community Property

- ▶ Half of income earned belongs to each spouse
  - Same impact as MFJ for income tax
- ▶ MFS
  - Community-property income split equally
  - Poses a problem if spouses are not cooperating

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## MFS and Community Property

- ▶ Separated Spouse Relief
  - Personal service income reported by the earner if
    - The couple lives apart at all times during the year
    - They do not file a joint return
    - None of earned community income is transferred between them
- ▶ Innocent Spouse Relief
  - May exclude community income from the spouse if
    - Do not file joint return
    - Show did not know or have reason to know of the community income
    - It is inequitable to include it in the taxpayer's income
- ▶ Equitable Relief
  - At discretion of the IRS
- ▶ Disallowance of Community Property Treatment
  - Secretary of Treasury can disallow benefits of community property

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## Income from Investment Activities

- ▶ Capital Gains
- ▶ Interest
  - Original Issue Discount
  - Gifting of Debt Instruments
- ▶ Dividend Income
- ▶ Rental and Royalty Income
- ▶ Annuity Distributions
- ▶ Income from Life Insurance and Endowment Contracts
- ▶ Traditional IRAs
- ▶ Income from Partnerships, S-Corps, and LLCs
- ▶ Income from Trusts and Estates
- ▶ Discharge of Indebtedness

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## Capital Gains Tax Rate

- ▶ **General Rule:** Maximum rate of 15% for long-term gains
  - Taxpayer in 15% (or lower) bracket - 0%
- ▶ **Exceptions:**
  - Collectibles - 28%
  - Unrecaptured Section 1250 Gain
    - Resulting from straight-line depreciation - 25%
- ▶ Effective rate may be more than maximum
  - Capital gains increase a taxpayer's AGI
  - Increased AGI may lead to phaseouts

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## Original Issue Discount (OID)

- ▶ Doctrine of Constructive Receipt
- ▶  $OID = \text{Maturity Value} - \text{Purchase Price}$
- ▶ TP recognizes imputed interest each year. As interest is recognized,
  - OID is amortized (reduced by the amount recognized)
  - The taxpayer's basis increases (by the amount recognized)
- ▶ **Exceptions:**
  - Series E and EE Savings Bonds

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## Original Issue Discount (OID) Example

On January 1<sup>st</sup> of this year Ivan purchases a 30 year zero coupon government bond at a market rate of 8% paying \$99.38. How much interest income does Ivan report this year?

$$\text{Income} = \$99.38 \times 0.08 = \$7.95$$

$$\text{New Basis} = \$99.38 + 7.95 = \$107.33 \text{ (at year end)}$$

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## Income Tax Issues Associated with Gifts of Debt Instruments

- ▶ Donee and donor report interest income based on number of days the instrument was held, regardless of who receives the payment
- ▶ There may also be gift, estate, and generation skipping transfer tax consequences
  - Covered in Estate Planning Course

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## Dividends

- ▶ Distribution of earnings by corporation
- ▶ Taxable to shareholders to extent of earnings
  - If distribution exceeds earnings, it is taxed
    - First, as a return of basis
    - Then, as capital gain
- ▶ **Qualified Dividends** – 0%/15% Tax Rate
  - Paid by U.S. corporation or qualified foreign corporation
  - Not excluded from definition of qualified dividend
  - Shareholder must meet holding period requirement
  - Expires 12/31/2012

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## Annuity Taxation

$$\text{Exclusion Ratio} = \frac{\text{Investment in the Contract}}{\text{Expected Return}} \times \text{Distributions Received}$$

- ▶ For Annuity Starting dates after 12/31/1986
  - Total exclusion cannot exceed investment in the contract
  - Un-recovered investment is taken as a deduction on the annuitant's final income tax return
- ▶ Withdrawals before age 59½ are also subject to a 10% early distribution penalty
  - Exceptions: Death and Disability
- ▶ Distributions prior to annuitization are taxed on LIFO basis

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## Income Taxation and Life Insurance

- ▶ Endowment Contracts
  - Payout before death = taxable income
- ▶ Surrender
  - Amount Realized – Basis = taxable income
- ▶ Death Benefit excluded from income (see exclusions)
  - Unless Transfer for Value Rule applies

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## Income Taxation and IRAs

- ▶ Generally, ordinary income
- ▶ Exceptions
  - Return of basis
    - Use exclusion ratio
  - Roth IRAs (excluded from income)
- ▶ Penalties
  - Too Early (Early Distribution – before 59½) – 10%, plus tax
  - Too Much – 6%, plus tax
  - Too Late – 50%, plus tax

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## Income Taxation of Business Entities

- ▶ Pass-Thru Entities
  - Partnerships
  - Limited Liability Companies
  - S-Corporations
- ▶ Income is taxed to owners based on ownership percentage
  - As income is recognized, owner's basis increases

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## Income Tax Rates for Estates and Trusts

If taxable income is:	2009 tax is:
Not over \$2,300	15% of taxable income
Over \$2,300 but not over \$5,350	\$345 plus 25% of the excess of such amount over \$2,300
Over \$5,350 but not over \$8,200	\$1,107.50 plus 28% of the excess of such amount over \$5,350
Over \$8,200 but not over \$11,150	\$1,905.50 plus 33% of the excess of such amount over \$8,200
Over \$11,150	\$2,879 plus 35% of the excess of such amount over \$11,150

If taxable income is:	2009 tax is:
Not over \$2,300	15% of taxable income
Over \$2,300 but not over \$5,350	\$345 plus 25% of the excess of such amount over \$2,300
Over \$5,350 but not over \$8,200	\$1,107.50 plus 28% of the excess of such amount over \$5,350
Over \$8,200 but not over \$11,200	\$1,905.50 plus 33% of the excess of such amount over \$8,200
Over \$11,200	\$2,895.50 plus 35% of the excess of such amount over \$11,200

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## Discharge of Indebtedness

- ▶ Debt forgiveness is an accretion to wealth
  - To the extent the tax payer is solvent, must include debt forgiven as income.
  - Other exceptions:
    - Certain student loans
    - Hurricane Katrina
    - Debt forgiven as a gift

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## Investment Income Excluded from Gross Income

- ▶ **Municipal Bond Interest**
  - Some exceptions apply
- ▶ **Life Insurance**
  - Death Benefits
  - Accelerated Death Benefits
- ▶ **Roth IRAs**
- ▶ **Education related exclusions**
  - Savings Bond Interest
  - Qualified Tuition Programs/529 Plans
  - Coverdell Savings Accounts
- ▶ **Improvement by Tenant to Landlord's Property**

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## Municipal Bond Interest

- ▶ Interest is exempt for regular tax purposes
  - Interest may also be excluded from state taxation
  - Capital gains are taxable
- ▶ Tax Equivalent Yield
- ▶ Equivalent Tax Rate

$$\text{TEY} = \frac{\text{Tax-Free Rate}}{1 - \text{Marginal Tax Rate}}$$

$$= \text{Taxable Rate} \times (1 - \text{Marginal Tax Rate})$$

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## Life Insurance Proceeds

- ▶ Death Benefits paid by reason of the death of the insured are exempt from income tax
  - Exception: Transfer for Value Rule
- ▶ Distributions from regular in-force policies
  - First, treated as return of basis
  - Next, treated as a loan
- ▶ Modified Endowment Contracts
  - FIFO basis – distributions taxable to extent of gain
- ▶ Accelerated Death Benefits
  - Terminally Ill – death expected in 24 months
  - Chronically Ill – proceeds must be used to pay medical expenses

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## Roth IRAs

- ▶ **Contributions not deductible**
- ▶ **Distribution is tax free if made**
  - After age 59½
  - After death or disability of the owner
  - For first-time home purchase (up to \$10,000)
- ▶ **FIFO Treatment applies**
  - Basis distributions are always tax free
- ▶ **Conversions**
  - No conversion limitation (AGI) applies (for years after 2009)

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## Education Exclusions

- ▶ Savings Bond Interest Income Exclusion
  - Qualified US Savings Bond
    - Must be EE bonds issued after Dec 31, 1989
    - Issued in the name of taxpayer and/or spouse
    - Bond owner must be 24 years old on date of issue
  - Subject to phaseout

*Phaseout MAGI amounts for Savings Bond Interest Exclusion:*

	2012	
MFJ & SS	\$109,250-\$139,250	
Others	\$72,850-\$87,850	

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## Education Exclusions

- ▶ 529 Plans
  - Distributions are tax free if used to cover qualified education expenses
  - Sponsored by states or higher education institutions
  - Can front-load with 5 annual exclusion gifts
    - \$13,000 x 5 = \$65,000 for 2012 per donor / per donee
  - No income phase-outs apply

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## Education Exclusions

- ▶ Coverdell Education Savings Accounts
  - \$2,000 maximum per year until beneficiary reaches age 18
  - Distributions are tax free if used to cover educational expenses, including
    - Qualified elementary/secondary school expenses
    - Special needs expenses
    - Contributions to 529 plans
  - Account must be used or rolled over by the time the beneficiary reaches age 30

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## Education Exclusions

- ▶ Coverdell Education Savings Accounts
  - Income phase-outs apply

MFJ	\$190,000-\$220,000
Others	\$95,000-\$110,000

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## Coverdell - Calculation of Reduction and Contributions Example

Tony and his wife Kate would like to make a contribution to a Coverdell Education Savings Account for their son, Jethro. Tony and Kate are married filing jointly and their AGI is \$200,500. Because they are in the phase-out range, Tony and Kate will not be able to make the maximum contribution of \$2,000. Instead, their contribution will be reduced by \$700. The contribution limit is \$1,300 (\$2,000 - \$700).

$$\$2,000 \times \frac{\$200,500 - \$190,000}{\$220,000 - \$190,000} = \$700 \text{ (Reduction)}$$

$$\$2,000 - \$700 = \$1,300 \text{ Contribution}$$

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## Income from Personal Activities

- ▶ Prizes and Awards
- ▶ Alimony and Separate Maintenance
- ▶ Imputed Interest on Below Market Loans
- ▶ Other Income
  - Gambling winnings
  - Fees for jury duty
  - Fees for being executor or personal representative
  - Hobby income

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## Prizes and Awards

- ▶ **General Rule: Included in Income**
  - If paid directly to charity at request of recipient, excluded from gross income if:
    - The prize was given primarily in recognition of religious, charitable, scientific, educational, artistic, literary, or civic achievement
    - The recipient must not apply for the award
    - The recipient must not be required to render substantial future services
  - Employee Achievement Awards are excluded if
    - Award is not in excess of \$400
    - Total awards to employee cannot exceed \$1,600

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## Payments to Former Spouses

- ▶ **Alimony**
  - Deducted (above the line) by payor
  - Taxable to payee
  - Pass-thru concept
- ▶ **Child Support**
  - No deduction permitted
- ▶ **Property Settlement**
  - No deduction permitted

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## "Alimony" Defined

- ▶ Payment in cash
- ▶ Pursuant to a divorce or separation instrument
  - Instrument must not designate the payment as something other than alimony
- ▶ Parties are not members of the same household
- ▶ Payments do not extend beyond death of payee
- ▶ Are not "excess alimony payments"
- ▶ Not between spouses filing jointly

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## What is Not Alimony

- ▶ Elective Non-Alimony Payments
- ▶ Child Support
  - Payments reduced upon a contingency specifically relating to a child will be treated as child support
- ▶ Rent-Free Occupancy of the Home

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## Alimony vs. Child Support Example

Under a provision of a divorce decree, Thomas is to pay his former spouse, Sheila, \$5,000 per month. Sheila has custody of their only child, Alex. When Alex reaches age 18, the payments are to be reduced to \$3,000 per month. The remaining \$3,000 is to be paid to Sheila for as long as she lives or until she remarries.

- \$2,000 of the \$5,000 is assumed to be child support because the payment is reduced when Alex reaches age 18 (a contingency related to a child).
- The remaining \$3,000 per year is deductible alimony.

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## Property Settlements at Divorce

- ▶ Transfer property between divorcing spouses
- ▶ No income tax deduction available
- ▶ Treated as a *gift* to a spouse for *income tax purposes* (IRC Section 1014)
  - No gain/loss recognized
  - Carry-over basis
- ▶ May be a disguised transaction
  - "Front-Loaded" Alimony

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## Front-loaded Alimony Payments

- ▶ 3-year review period
- ▶ In the 3<sup>rd</sup> post-separation year,
  - Excess payments included in payor's taxable income
  - Payee has a deduction equal to the amount includible in the payor's income in that year
- ▶ Changes nature of excess payments from alimony to a property settlement

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## Amount of Excess Alimony

- ▶ Total Recapture = R2 + R1
- ▶ Second year:
  - $R2 = P2 - (P3 + \$15,000)$
- ▶ First year:
 
$$R1 = P1 - \left[ \frac{(P2 - R2) + P3}{2} + \$15,000 \right]$$
- ▶ Or use ,  $R3 = P1 + P2 - 2P3 - \$37,500$  if the decline is at least \$15,000/year.

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## Alimony Recapture

- ▶ Bonnie paid Dominic alimony payments of \$80,000 (2010), \$40,000 (2011), and \$10,000 (2012). Is there alimony recapture?
- ▶  $P1 = \$80,000$ ;  $P2 = \$40,000$ ; and  $P3 = \$10,000$
- ▶  $R2 = P2 - (P3 + \$15,000)$
- ▶  $R2 = \$40,000 - (\$10,000 + \$15,000)$ ;  $R2 = \$15,000$
- ▶  $R1 = P1 - \left[ \frac{(P2 - R2) + P3}{2} + \$15,000 \right]$
- ▶  $R1 = \$80,000 - \left( \frac{(\$40,000 - \$15,000) + \$10,000}{2} + \$15,000 \right)$ ;  $R1 = \$47,500$
- ▶  $R3 = R1 + R2$
- ▶  $R3 = \$47,500 + \$15,000$ ;  $R3 = \$62,500$
- ▶ Or, shortcut formula\*  $R3 = (P1 + P2) - 2P3 - \$37,500$
- ▶  $R3 = (\$80,000 + \$40,000) - \$20,000 - \$37,500$ ;  $R3 = \$62,500$

\* Used if payments decreased by more than \$15,000 per year over first three years.

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## Special Issues with Divorce Settlements

- ▶ **Medical Insurance**
  - Treated as alimony in entirety if the agreement does not specify what part was for the child's support
- ▶ **Life Insurance**
  - Payee spouse is owner
    - Premium payments made by payor spouse are alimony
  - Cash values are not considered to be alimony
  - Payee spouse is named as beneficiary
    - Premium payments are not alimony
    - Death benefit included in payor spouse's estate
    - Death benefit is tax free to payee spouse

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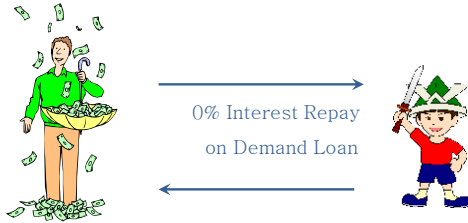
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## Imputed Interest Rules



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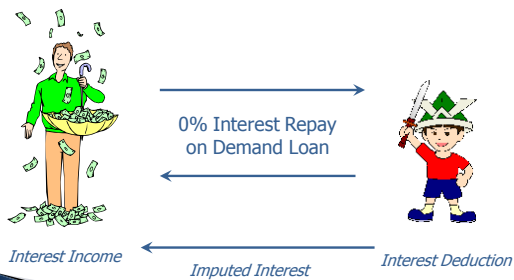
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## Below-Market Loan - IRS



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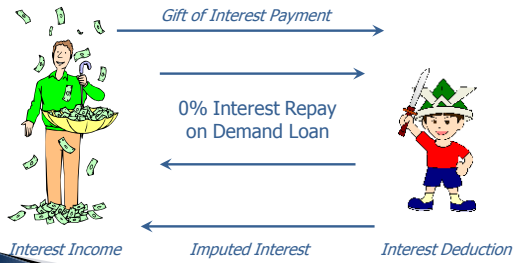
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## Below-Market Loan - IRS



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## Below-Market Loans

- ▶ Corporation to Shareholder
  - Treated as a dividend to shareholder
  - Returned to employer as interest income
- ▶ Loan to Employee
  - Treated as paid compensation for employee
    - Subject to employment taxes
  - Returned to employer as interest income
    - Not deductible by the employee
    - Taxable to the employer

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## Below-Market Loan Rules

- ▶ Apply to
  - Term or demand loans that are gift loans, or
  - Tax avoidance loans

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## De Minimis Exceptions

Loan Value	Imputed Interest
\$0 ≤ \$10,000	\$0 if not used for acquiring income-producing assets
\$10,001 ≤ \$100,000	The lesser of: • Net investment income, or • Interest calculated using AFR less interest calculated using stated rate of loan. If borrower's net investment income ≤ \$1,000, \$0 imputed interest.
> \$100,000	Interest calculated using AFR less interest calculated using stated rate of loan.

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## Tax Benefit Rule

- ▶ Taxpayer takes a deduction in one tax year, and
- ▶ Recovers (e.g., receives a refund) part or all of the expenditure in a later year,
- ▶ The recovered amount should be included in gross income in that later year.

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## Other Personal Source Income

- ▶ Gambling winnings
- ▶ Fees for
  - Jury duty,
  - Serving as executor, administrator, or personal representative of an estate (unless you are a professional)
- ▶ Income from a hobby

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## Personal Exclusions

- ▶ Gifts
- ▶ Inheritances
- ▶ Scholarships
- ▶ Compensation for Injuries and Sickness (Limited)
- ▶ Child Support and Property Settlements
- ▶ Gain on the Sale of Personal Residence (Limited)
- ▶ Amounts Received under Contracts for Certain Living Expenses
- ▶ Qualified Foster Care Payments
- ▶ Disaster Relief Payments

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## Scholarships

- ▶ Excluded if:
  - Candidate for a degree
  - At an eligible educational institution
  - Proceeds are used for qualified tuition & related expenses
    - Tuition
    - Fees
    - Course related expenses (books, supplies, equipment)
- ▶ Qualified Tuition Reductions
  - Excluded from Income
  - Pell Grants

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## Compensation for Injuries and Sickness

Inclusion and Exclusion Taxable Income		
Injury Type	Compensatory Damages	Punitive Damages
Bodily injury	Excluded	Included
Personal injuries not including bodily injury	Included	Included
Lost income	Included	Included
Any other type of injury	Included	Included

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## Qualified Disaster Relief Payments

- ▶ Received for
  - Reasonable and necessary
    - Personal, family, living or funeral expenses
    - Expenses to repair or rehabilitate a personal residence or its contents
  - Promoting general welfare
  - Paid by common carrier by reason of the death or personal physical injuries incurred
- ▶ Qualified disaster
  - Terroristic/military action
  - Presidentially declared disaster
  - Accidents involving common carriers

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